EXECUTIVE SECRETARIAT

Routing Slip

TO:

		ACTION	INFO	DATE	INITIAL
1	DCI		✓		
2	DDCI				
3	EXDIR				
4	D/ICS				
5	DDI				
6	DDA				
7	DDO				
8	DDS&T				
9	Chm/NIC				
10	GC				
11	IG				
12	Compt				
13	D/EEO				
14	D/Pers				
15	D/OEA				
16	C/PAD/OEA				
17	SA/IA	✓			
18	AO/DCI				
19	C/IPD/OIS				
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SUSPENSE ________________
Date

Remarks:

[redacted] 25X1

Executive Secretary
11/18/82
Date

3637 (10-81)

Approved For Release 2009/04/01 : CIA-RDP83M00914R002300010007-3

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CABINET AFFAIRS STAFFING MEMORANDUM

DATE: 11/18/82 NUMBER: 077605CA DUE BY:

SUBJECT: November 19 Cabinet Council on Commerce and Trade 2:00 - 3:00 Cabinet Room

	ACTION	FYI
ALL CABINET MEMBERS	☑	☐
Vice President	☐	☐
State	☐	☐
Treasury	☐	☐
Defense	☐	☐
Attorney General	☐	☐
Interior	☐	☐
Agriculture	☐	☐
Commerce	☐	☐
Labor	☐	☐
HHS	☐	☐
HUD	☐	☐
Transportation	☐	☐
Energy	☐	☐
Education	☐	☐
Counsellor	☐	☐
OMB	☐	☐
CIA	☐	☐
UN	☐	☐
USTR	☐	☐
CEA	☑	☐
CEQ	☐	☐
OSTP	☑	☐
	☐	☐
	☐	☐

	ACTION	FYI
Baker	☑	☐
Deaver	☐	☐
Clark	☐	☑
Darman *(For WH Staffing)*	☑	☐
Harper	☑	☐
Jenkins	☐	☑
Wheeler	☐	☑
Kudlow	☐	☑
	☐	☐
	☐	☐
	☐	☐
	☐	☐
	☐	☐
CCCT/Gunn	☑	☐
CCEA/Porter	☐	☐
CCFA/Boggs	☐	☐
CCHR/Carleson	☐	☐
CCLP/Uhlmann	☐	☐
CCMA/Bledsoe	☐	☐
CCNRE/Boggs	☐	☐

REMARKS: The Cabinet Council on Commerce and Trade will meet Friday, November 19 at 2:00 p.m. The President will chair the first thirty minutes of the meeting. Attached is the paper on DISC Alternatives provided by the Department of the Treasury. The background paper for the first agenda item was distributed to you on 11/16/82. This meeting will follow the 1:00 Cabinet meeting.

CONFIDENTIAL

ATTACHMENTS

RETURN TO:

☐ Craig L. Fuller
Assistant to the President
for Cabinet Affairs
456-2823

☑ Becky Norton Dunlop
Director, Office of
Cabinet Affairs
456-2800

DCI EXEC REG

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CONFIDENTIAL ATTACHMENT

OFFICE OF THE SECRETARY OF THE TREASURY
WASHINGTON, D.C. 20220

November 18, 1982

MEMORANDUM FOR WENDELL GUNN
EXECUTIVE SECRETARY
CABINET COUNCIL ON COMMERCE & TRADE

SUBJECT Treasury Paper for November 19 Meeting

Attached is Treasury's paper on alternatives to DISC for distribution to members of the CCCT for the meeting scheduled for November 19.

DC

David L. Chew
Executive Assistant
to the Secretary

Attachment

CONFIDENTIAL ATTACHMENT

Export Incentives

Summary

The attached paper responds to the Cabinet Council on Commerce and Trade request for an analysis of export incentives. The major conclusion is that a general export incentive is unsound economic policy. While a broad-based incentive will increase exports, it will have a number of undesirable effects. The U.S. economy, for example, will be worse off because the terms of trade will deteriorate, i.e., more exports will be exchanged for a given volume of imports. Thus, the total amount of goods and services available to the U.S. economy will fall. A general export incentive tends to move labor and capital from import competing industries, such as steel and automobiles, to export industries, such as airplanes and computers. While the export industries benefit, the competitive pressures on the import competing industries are increased.

Because the economic rationale for a general export incentive is weak, repeal of DISC, perhaps tied to a reduction in the corporate income tax, would be the best answer to the GATT problem. This is not, however, politically acceptable. Further, any general tax incentive that would be GATT legal would not only be bad economic policy, but would require that U.S. exporters move part of their operations to tax havens.

As alternatives to the present DISC, a number of other export incentives are considered in the paper. They range from enhanced Eximbank funding to the use of resources freed by repeal of the DISC for a program of agricultural export subsidies targeted against the EC. We find, however, that these proposals, like the tax-related alternatives to the present DISC, also have many disadvantages and drawbacks. Nevertheless, to the extent that such alternatives could be targeted against particularly offensive foreign practices which affect U.S. exporters, they might have merit.

November 17, 1982

EXPORT INCENTIVES

I. ISSUE

At the October 1 meeting of the General Agreement on Tariffs and Trade (GATT) Council, the U.S. representative moved to end the decade-long dispute over the DISC by stating that the Administration would propose legislation to address the concerns of other GATT members. While making no commitment on the content of the proposed legislation, the U.S. delegate also indicated that the Treasury Department would analyze various alternatives. This paper responds to a Cabinet Council on Commerce and Trade (CCCT) request for that analysis.

Section II contains an economic analysis of general or broad-based export incentives. It explains that while export incentives increase exports, they also worsen the U.S. "terms of trade." That is, the U.S. economy suffers an overall loss because more exports are surrendered for a given volume of imports. The section also explains that general export incentives tend to draw resources out of other producing sectors of the economy, rather than increase the total level of production, employment, savings, and investment. Even if export incentives increase aggregate economic activity, other economic policy tools can achieve the same objective while benefitting a wider group of U.S. industries. The basic conclusion of section II is that the economic case for general export incentives is weak.

Section III analyzes general export tax incentive alternatives to DISC. It contends that most of the current tax proposals would run afoul of U.S. commitments in GATT. This is a fatal defect of these proposals since their primary objective is to solve the GATT problem and thereby enable the United States to vigorously pursue a program of trade expansion and once again use the GATT as a dispute settlement mechanism. Section III presents an alternative that arguably would comply with GATT rules, but since it would be bad economic policy and require U.S. exporters to move part of their operations to tax havens, section IV proposes several non tax options. However, these options also have disadvantages. Nevertheless, to the extent that such alternatives could be targeted against particularly offensive foreign practices which affect U.S. exporters, they might have merit.

II. ECONOMIC ANALYSIS OF EXPORT INCENTIVES

An export incentive is any policy measure designed specifically to promote increased exports. It gives U.S. business, for example, an incentive to sell to India rather than Indiana. This definition does not include general policy measures which are expected, as part of a broader result, to have a positive effect on exports, such as measures to increase productivity in the manufacturing sector or to reduce U.S. tax on all foreign source income.

Export incentives increase exports by lowering the cost of exports compared to domestically produced and consumed goods and services. For example, DISC lowers the cost of capital to the export sector by decreasing the pre-tax profits required to earn a given after-tax return. Similarly, government sponsored trade fairs lower marketing costs. As export prices decline relative to other prices, export sales expand.

U.S. export incentives impose a real cost on the U.S. economy by reducing the terms of trade. U.S. exports are not a desirable objective in and of themselves. They are, in fact, a cost to the economy because they allow foreigners to appropriate part of the goods and services produced by the U.S. economy. In exchange for exports, the United States, of course, is able to import goods and services produced by another country. Imports are the gain from trade and exports are the cost of that trade. Export incentives worsen the terms of trade by requiring the economy to surrender more goods and services in exchange for a given volume of imports.

Export incentives also have important sectoral or industry effects on the U.S. economy. As exports increase, capital, labor, and other inputs are attracted into the export sector. These resources may be drawn from a variety of sources. The capital flowing into export production may come from elsewhere in the domestic goods producing sector, other domestic sectors such as services and housing, the foreign operations of U.S.-based companies, new saving stimulated by higher returns, or from greater foreign investment in the United States. Similarly, the new jobs in the export sector may represent a shift of labor from other sectors or a net increase in total employment due to reduced unemployment or increased labor supply. In short, export incentives may simply move capital and labor from one sector to another, or they may increase the total amount of available capital and labor.

A. Foreign Responses to U.S. Export Incentives

The evaluation of export incentives depends largely on which of these various sources of capital and labor are likely to be most significant. The relative significance of these various sources determines whether export incentives result in a net increase in economic activity or simply a rearrangement among domestic sectors. Their relative importance depends on how the economy adjusts to an expansion in exports. The increase in exports stimulated by incentives will increase the foreign demand for dollars. Because a country's accounts must always be in balance, foreigners will somehow have to finance their increased dollar requirements. The way in which these requirements are financed determines the source of new capital and labor to the export sector.

1. Domestic import competing sectors. Foreigners can finance their increased imports from the United States by selling more goods to the United States. U.S. imports will increase because the increased foreign demand for dollars will cause the dollar to appreciate, making foreign goods cheaper in dollars to U.S. consumers. The appreciation of the dollar also increases the price of U.S. exports in foreign markets and moderates the increase in exports that could have taken place without the change in exchange rates. The increased imports displace some import-competing production in the United States. Thus, the increase in U.S. imports causes resources to flow out of import-competing production in the United States and into export production. An increase in imports is likely to be the predominant method for financing the increase in U.S. exports because the others do seem not to be as significant.

2. Direct investment and multinational location. Apart from increased imports, a change in direct investment is the other important way that an increase in U.S. exports can be

financed. An export incentive may induce U.S. multinationals, who can supply a foreign market from either U.S. or foreign production, to choose the United States. This shift in foreign direct investment would finance the increase in foreign demand for U.S. exports by reducing flows of investment income from abroad. Because they are directed to manufacturing capital which is highly mobile internationally, export incentives may be a relatively effective way of attracting foreign capital. (Foreign affiliates accounted for 25 percent of the total assets of U.S. multinational manufacturing companies in 1977.) In contrast, a small reduction in corporate taxes with the same overall revenue cost may be a more indirect method of attracting capital from abroad. While the general reduction in taxes may cause U.S. firms to expand their purely domestic (non-export) operations, this new investment may be financed out of U.S., rather than foreign, saving.

3. <u>U.S. acquisition of foreign assets</u>. Alternatively, the United States might lend foreigners the dollars to finance their increased purchases from the United States. The Export-Import Bank, for example, could lend the money long-term at below market rates. Or, U.S. private investors might provide the needed dollars by buying foreign assets, such as through direct or portfolio investment. This is an unlikely by-product of an

export incentive program, however, because relative after-tax rates of return are, if anything, likely to increase in the United States compared to foreign locations.

4. Foreign portfolio investments in the United States. As a final alternative, foreigners might place their savings in the United States in the form of portfolio investment and use the U.S. interest and dividends to pay for their increased imports. This might happen if higher overall after-tax returns in the U.S. attract foreign portfolio investment or if lower export prices made possible by an incentive program lower the profitability of investment in competing sectors abroad and cause capital to flow into the United States.

Export incentives are not, however, an effective means of raising after-tax returns in order to attract foreign portfolio investment. It would be preferable in terms of either tax revenue or economic efficiency to raise the overall U.S. returns by spreading the benefits to all investments, not just export industries, e.g., by reducing the rate of withholding tax on dividends received by foreigners.

Any flow of foreign capital is likely to be small. International portfolio investment is a relatively insignificant outlet of domestic saving for most industrialized countries. If rates of return decline in foreign export sectors, the capital will probably flow to other uses in the foreign country in which it originates.

B. Domestic Responses to U.S. Export Incentives

In addition to the balance of payments adjustments, export incentives may generate adjustments within the U.S. domestic economy.

1. Domestic saving. Export incentives may increase the demand for capital in the United States and thus raise the return earned by savers. This is particularly true of a capital incentive such as DISC. Export incentives are, however, relatively inefficient as savings incentives because all of their benefits are concentrated in export production. The same increase in saving could be realized with much less revenue loss and more economic efficiency by spreading the benefit to all capital, e.g., by lowering corporate tax rates generally.

2. Increased employment. Export incentive programs increase employment in the export sector but, largely at the expense of employment in import competing industries. They may, in fact, exacerbate transitional adjustment problems by increasing the demand for workers who have little trouble finding jobs and

reducing demand in declining sectors in which laid-off workers go through long spells of unemployment. If, however, export incentive programs attract capital from abroad or increase saving, employment may increase both because of new job opportunities and because of the increased supply of workers responding to higher real wages. While this is an attractive characteristic in a time of economic slack, it would be more desirable to stimulate employment with a general economic policy tool applicable to all industries.

C. Conclusions on the Relative Significance of the Potential Sources of Capital and Labor

Except for a possible shift in operations by U.S. multinationals, the added capital and labor in export industries will come largely from domestic import-competing industries. Any net increase in domestic saving and employment, and in foreign portfolio investment, are either insignificant or can be achieved more effectively with other policies.

D. Role of Exchange Rates

For convenience of exposition, the above analysis is couched in terms of changes in exchange rates. The analysis, however, does not depend on fluctuating rates, although they do smooth the adjustment process. The important effects of incentives involve changes in relative prices and these changes will occur even if exchange rates are fixed. Very briefly, an export incentive, will cause exports to increase. The export sector will bid capital and labor away from other sectors by offering high rates of return and wage rates. This will increase costs in the import competing sectors and cause imports to be substituted for domestic production. The result of the export incentive is more exports and more imports.

E. Specific Arguments for Export Incentives

Five basic arguments are used to justify export incentives. The first three of these formed the original justification for the DISC program.

1. Argument. Exports incentives are necessary to offset lower taxes in countries which compete with the United States in export markets.

Evaluation. Export competitiveness depends on the structure of taxes, not their absolute level. That is, it depends on how export industries are taxed compared to import-competing industries in the United States. If export and import-competing industries are taxed equally, then exports are not at any disadvantage because the resulting depreciation of the dollar will restore the "no-tax" pattern of trade by raising the price of imports to their previous relationship with import competing goods and reducing the price of exports to foreigners.

If export industries are taxed more heavily than import-competing industries, both exports and imports will be reduced. U.S. export industries do not appear to bear a higher burden than import-competing goods. Agricultural exports, for example, bear low taxes because of the relative insignificance of the corporate income tax in agriculture. If the comparison is restricted to the manufacturing sector, import competing and export industries have about the same rate of tax on capital income.

The overall level of tax may affect competitiveness through its impact on saving in the United States. But as explained above, export incentives are not an efficient savings incentive. The Administration believes that saving and capital formulation are best encouraged by broad-based investment incentives and reductions in marginal tax rates.

2. Argument. Export incentives are necessary to offset export incentives offered by competing countries.

Evaluation. Exporters in other industrialized countries may benefit from programs designed to increase exports. It may well be, for example, that U.S. manufacturing exports bear a higher rate of tax and receive less government assistance than those in some significant competing countries. Providing similar benefits in the United States may therefore seem "fair" in permitting U.S. exporters to compete.

But this is an argument for specific, not general, export incentives. As explained above, a generalized program of export incentives generates both more exports and more imports. If a foreign country is subsidizing its exports to the United States, it also will be buying more from U.S. exporters. There is no doubt that a sizable and industry-targeted foreign export incentive can seriously damage the same industry in the United States. The United States can save that industry by subsidizing it, but this will make other U.S. industries less competitive.

3. Argument. Export incentives are needed to offset the opportunities for tax deferral enjoyed by U.S. multinationals by locating abroad.

Evaluation. Under U.S. law, tax on the profits of an overseas manufacturing subsidiary of a U.S. taxpayer is deferred until those profits are repatriated. But, absent DISC, income from export sales of goods produced in the United States is taxed in the United States on a current basis. U.S.-based companies, by establishing manufacturing facilities in low-tax countries and reinvesting their earnings abroad, can reduce their tax rates below effective rates in the United States. Export incentives reduce the cost of supplying a foreign market from the United States and may therefore induce a flow of capital back into the United States.

It is unclear how substantial this reverse flow may be since U.S. foreign investment does not appear to be motivated by tax considerations. The U.S. Commerce Department's Benchmark Survey of U.S. Direct Investment abroad for 1977 indicates that only about 20 percent of the total income of U.S. manufacturing affiliates was in countries in which they paid foreign income taxes equal to less than 40 percent of book income. Furthermore, they paid less than 25 percent in only a few significant foreign locations.

In addition, the Economic Recovery Tax Act (ERTA) of 1981 significantly reduced the tax rate on new manufacturing investment in the United States, even after the recent modifications are considered. ACRS has lowered the effective tax rate on the average new investment in plant and equipment in manufacturing as a whole to about what it was on export investment, inclusive of DISC benefits, before ERTA.

4. Argument. Export incentives enable U.S. business to compete and increase employment.

Evaluation. Export incentives undeniably increase exports. By definition, they benefit firms that export. But they do so at a cost. They worsen the U.S. terms of trade and put added pressure on import competing industries. While employment is increased in the export sector, it is at the expense of employment in import-competing industries. In effect, expanded employment in the export sector is "paid for" by reduced employment in the import competing sector. If unemployment is the problem, it is preferable to reduce it with more general economic policy tools.

5. Argument. Export incentives are needed to overcome market imperfections and enable U.S. corporations to exploit economies of scale.

Evaluation. The existence of market imperfections and economies of scale are not persuasive arguments for export incentives. Penetrating a foreign market may be expensive because of the cost of acquiring market information, but this justifies government involvement only if the government knows something the private sector does not. The need for information and communication create opportunities for specialized private marketing firms to provide services to exporters. If the government has an advantage in acquiring trade information, potential exporters should be willing to pay user fees to finance the activity. Similarly, economies of scale may greatly increase the benefits of selling in foreign markets, but manufacturers are best able to assess their own costs. If expanding their market permits them to exploit scale economies, U.S. exporters will aggressively seek foreign markets. It is very common, in electronics for example, for manufacturers to price new products below current average costs because they know that expanding demand will drive down unit costs and create substantial profits.

III. TAX ALTERNATIVE TO THE DISC

A. Summary.

The tax incentive alternatives to DISC that have been proposed publicly would most likely violate the GATT rules. A necessary element of any tax alternative in substantive compliance with the GATT (other than a wholesale modification of U.S. taxation of all foreign source income to a European style territorial tax system) is the requirement that economic activity be conducted outside the United States through a foreign corporation in order to obtain relief from current U.S. taxation. Further, arm's-length transfer pricing rules must be used to determine the income of the foreign corporation. Such a GATT legal measure to promote exports would encourage the use of tax havens, as well as being impractical for small businesses. Thus, while a GATT legal alternative is set forth in section D, it is concluded such a tax based export incentive is not desirable.

B. Standards for Determining When a Tax Practice Will be an Export Subsidy Under GATT and the Subsidies Code.

Both the GATT And Subsidies Code rules prohibit preferential taxation of exports. For example, any exemption, remission, or deferral of income tax "specifically related to exports," or export activity, is proscribed as an export subsidy. [GATT Article XVI:4; Subsidies Code, Annex, Item (e)]. An exception from this general rule exists for measures "to avoid the double taxation of foreign source income" (the "double taxation exception"). [Subsidies Code, Annex, Item (e) fn. 2.] The GATT Council has further clarified the meaning of Article XVI:4 of the GATT, stating that "economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country" do not have to be taxed by the exporting country and, further, should not be considered "export activities" for purposes of Article XVI of the GATT. [GATT Council Resolution, adopted December 8, 1981.] Special deductions "directly related to exports or export performance, over and above those granted in respect of domestic production" also are prohibited [Subsidies Code, Annex, Item (f).]

Although the GATT and Subsidies Code rules prohibit reduced taxation of income from export activities, it is not necessary to tax income attributable to economic processes or transactions, including those involving exports, located outside the taxing country because such activities are not considered export activities for purposes of GATT. A method of taxation which exempts or defers the tax on export income earned outside the exporting country is therefore acceptable under international rules. Under such a method, income from economic processes located in the exporting country must be taxed, but income from economic activity occurring outside the exporting country may be exempt. An important caveat requires these amounts of income to be determined under arm's-length transfer pricing rules. Violation of the arm's-length principle with respect to income from exports is a prohibited export subsidy. A safe harbor transfer pricing rule should not be a violation of GATT if it is consistent with the arm's-length principle.

C. <u>Evaluation of Tax Alternatives</u>.

To properly solve the GATT problem, the Administration has stated publicly that any DISC alternative must be in substantive compliance with the GATT. This is an essential requirement. Otherwise, past disputes will be perpetuated and the Administration's use of GATT as a dispute settlement mechanism will be compromised. Although it has not been proposed as a solution, this paper briefly considers the alternative of adopting a territorial system of taxation for all foreign source income. This alternative, however, is rejected because it would be a major change in U.S. tax policy, transcending the export issue, and would not be necessary to solve the GATT problem. The other alternatives considered in this section would violate GATT because they would not require any foreign economic activity and/or would not comply with the arm's-length standard for transfer pricing. In section D, a tax alternative which substantively complies with GATT and the Subsidies Code is described.

1. Adoption of A Territorial System of Taxation

Description. The United States could adopt the "territorial" or "exemption" system of taxation for all income from foreign activities. Under this system, the United States, which presently taxes the worldwide income of U.S. citizens, residents, and corporations, with allowance of a dollar for dollar credit for foreign taxes, would not tax income earned outside the United States, whether such income is from foreign manufacture, services, or sales of goods. Thus, under a territorial tax system, income attributable to "economic processes" located outside the United States, whether in a branch or foreign subsidiary, would be exempt. The income attributable to foreign economic activity would be determined under basic U.S. (arm's length) transfer pricing rules.

A shift to a territorial system of taxation for all foreign source income would be a major change in U.S. tax policy. The present system is based on the worldwide taxation of citizens and residents which, after allowance of a foreign tax credit to alleviate international double taxation, generally promotes equal taxation of domestic and foreign source income. A territorial system would be based on different concepts. It is not necessary, however, to evaluate these alternative sets of concepts since a properly designed method of taxing export activity, i.e., one which exempts from current taxation the income derived from economic activity occurring outside the United States and relies on arm's-length transfer pricing, probably would be acceptable under GATT. In short, solving the GATT problem does not require the United States to adopt a territorial system of taxation.

2. "Onshore" Alternatives

Neither of the two alternatives discussed below requires any foreign economic activity. Consequently, neither alternative would be acceptable under GATT.

a) Deduction Against Foreign Source Income From Export Sales

Description. This alternative would require no foreign economic activity, but would allow a deduction against the foreign source income component of an export sale. For example, if a U.S. manufacturer sells goods to a foreign customer directly from the United States (i.e., not through a foreign subsidiary or branch), under the Code's present source of income rule for sales of property produced in the United States and sold outside the United States (i.e., with title passing to the foreign purchaser in the foreign country), it is possible to treat 50 percent of the income from the sale as foreign source income. In determining taxable income, this proposal would allow a special deduction for a specified portion of that foreign source income. Because of the deduction, the foreign source income from an export sale would be taxed at a reduced rate.

Analysis. This proposal violates GATT because the special deduction does not pertain directly to economic activity occurring outside the United States. Since the foreign source income component may be determined without requiring any foreign economic activity the special deduction would constitute a partial exemption of tax specifically related to exports, proscribed under the GATT.

b) The Macdonald Proposal

Description. Under Ambassador Macdonald's discussion proposal, an exporting company would calculate the amount of income which would be deferred from current tax as if the company had a

DISC, using existing DISC rules. The company would be entitled to exempt the lesser of that amount of income or the foreign source income of the company (whether or not derived from exports) determined by applying the present U.S. source of income rules.

Analysis. This proposal also violates the GATT requirement that income from export activity occurring within a country not be allowed special beneficial tax treatment. As with the first "onshore" alternative, the deduction or exemption is calculated with reference to exports while the U.S. exporter is not required to conduct any foreign economic activity.

3. "Offshore" Alternatives.

a) FISC

The FISC proposal would reincorporate DISCs in foreign jurisdictions without changing any of the other DISC rules, including the qualification (e.g., satisfaction of export receipts and export assets tests), safe harbor transfer pricing, and tax deferral provisions. Like the DISC, the FISC would not be subject to U.S. tax at the corporate level. In addition, the general requirements of corporate substance, which are relaxed for DISC purposes, would also be relaxed for a FISC. What appears to be contemplated is nothing more than a change in the place of incorporation, continuing the practice of using offices and employees of a parent shareholder to undertake the DISC (FISC) paperwork.

Analysis. The FISC proposal is intended to comply only in the most formalistic sense with the GATT. It attempts to create a territorial system of taxing exports by only changing the country of incorporation. There is no requirement, however, for the foreign corporation to have any economic substance. The FISC probably would conduct activities in the United States. Ordinarily, foreign corporations engaged in a U.S. trade or business are subject to U.S. tax on the income from that trade or business. Since a FISC would be required to satisfy DISC-type export receipts and export assets tests and would not be subject to U.S. tax at the corporate level, the result would be a prohibited tax exemption specifically related to exports. Moreover, the FISC would be allowed to use the DISC safe harbor transfer pricing rules, which would also violate the GATT arm's-length pricing requirement.

b) ESC: The Boren Bill (S. 2708)

Description. The Boren bill would provide special tax treatment for electing "export sales corporations" ("ESCs") organized in a foreign country or a U.S. territory or possession, other than Puerto Rico. An ESC would be required to meet export receipts and export assets tests similar to those for a DISC. The ESC would, like the DISC and FISC, be exempt from U.S. tax. Thus, the ESC could conduct activity in the United States and receive interest income from the United States without being subject to tax. There appears to be no foreign presence requirement to obtain ESC benefits, other than the requirement that the ESC be subject to income tax in its country of incorporation.

The income of the ESC would be determined under safe harbor transfer pricing rules similar to the DISC's. ESC shareholders would be deemed to receive as a dividend their pro rata share of the entire taxable income of the ESC for the year. The shareholders, however, would be entitled to a dividends received deduction of 32 percent of the dividends in lieu of a foreign tax credit. This is intended to provide an export taxation benefit roughly equivalent to DISC before the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). The revenue cost of the Boren bill therefore would be approximately equal to the pre-TEFRA cost of DISC.

Analysis. Like the FISC, the ESC would require a minimal foreign presence and could conduct activities in the United States. Since the income from these activities would not be subject to U.S. tax, there would be a prohibited exemption from tax specifically related to export activity. Because of a lack of required foreign economic substance, continued reliance on DISC safe harbor transfer pricing rules also would render this proposal a violation of the GATT's arm's-length transfer pricing requirement. Finally, the incorporation of an ESC in a U.S. territory or possession is unlikely to meet the GATT requirements for economic activity to occur outside the taxing jurisdiction, because U.S. territories and possessions are subject to the ultimate taxing jurisdiction of the United States.

c) ISC: The Frenzel Bill (H.R. 5179).

Description. The Frenzel Bill, as originally introduced in December, 1981, provides special tax treatment for corporations which meet DISC-type export receipts and export assets tests and which elect to be treated as an "international sales corporation" ("ISC"). An ISC would have four or fewer shareholders owning at least 25 percent of the corporation each. It would not be permitted to have a U.S. office or fixed place of business. Representative Frenzel has stated his intention to modify both requirements to facilitate use of ISCs by small businesses.

The income allocable to the ISC in a transaction with a related party would be determined under safe harbor transfer pricing rules similar to those for DISCs. The ISC would be excluded from the subpart F rules, thus allowing deferral of U.S. tax. The shareholders would receive a 100 percent deduction for dividends from the ISC, other than qualifying distributions. In effect, ISC export income would be exempted from U.S. tax.

Congressman Frenzel released a modified draft of his bill on October 21, 1982. The incentive was expanded to include international services, as well as export sales, income of an "international sales and services corporation" ("ISSC"). The ISSC could have up to 35 shareholders. Small businesses would be allowed to maintain an office in the U.S. Safe habor transfer pricing rules similar to those for the DISC would be allowed. An ISSC would be required to distribute to its shareholders annually at least 50 percent of its income. ISSC shareholders would be taxed on such dividends subject to a deduction equal to 40 percent of the dividend, and apparently would be entitled to a deemed paid foreign tax credit with respect to the taxable portion of the dividend.

Analysis. Unless these proposals require sufficient foreign economic substance to justify use of the DISC-type safe harbor transfer pricing rules, they would violate the GATT's arm's-length pricing requirement. Since the ISSC would be required to satisfy DISC-type export receipts and export assets tests, the safe harbor transfer pricing rules would result in a prohibited deferral and/or exemption of tax on income specifically related to exports.

The ISC would create an export-related tax benefit which is greater than the present DISC benefit. The newly-proposed ISSC, on the other hand, might not fit within the GATT's exception for measures to avoid double taxation of foreign source income since it provides a deduction, as well as a foreign tax credit, with respect to dividends from the ISSC.

The revenue cost of the October 21, 1982, version of the Frenzel bill would be about 2.4 times the cost of DISC after TEFRA.

4. Summary of the Above Discussed Alternatives

All of the foregoing proposals, except the pure territorial approach, would be vulnerable to attack under GATT and the Subsidies Code. The "onshore" alternatives require no foreign economic presence. The DISC-type safe harbor transfer pricing rules of the "offshore" alternatives would violate the arm's-length requirement unless the income so allocated is attributable to substantive economic activity of the foreign corporation.

In Treasury's view, the only alternative that would be successful against attack in the GATT would require actual foreign economic activity and would require arm's-length transfer pricing. The requirement of actual foreign presence, however, effectively requires that the entity be organized in a low or zero tax jurisdiction, i.e., a tax haven. This is to allow the U.S. exporter to obtain a lower rate of taxation than is available in the United States. It is Treasury's position that this is an unacceptable means of promoting exports for two reasons. First, to the extent that the foreign activity is substantive, it will require that economic activity and jobs formerly performed in the United States be performed outside the United States, possibly by non-U.S. persons. More significantly, the Treasury Department, Internal Revenue Service, and Department of Justice all have been engaged in combatting tax haven use, whether for criminal tax evasion, illegal civil tax abuses, or arguably legal, but unintended tax avoidance schemes. The United States government should not be in the position of actively encouraging the use of tax havens.

D. A "GATT Legal" Alternative: A Foreign Export Trading Income Exception to Subpart F

Description. This alternative would allow an exception from subpart F taxation of earnings attributable to the qualified export receipts of a controlled foreign corporation (CFC). The earnings and profits of the CFC attributable to such income (referred to as "foreign export trading income" or "FETI") would therefore not be taxed currently in the hands of the U.S. shareholders of the CFC, but would only be taxed when actually repatriated. The deferral of U.S. taxation of FETI income would be comparable to the deferral of tax on DISC taxable income.

Subpart F would also be modified to allow a CFC to loan funds attributable to FETI to its U.S. shareholders. A remaining technical issue is how to allow such loans to avoid the imposition of the U.S. tax on interest paid to foreign corporations not engaged in business in the United States. DISCs currently are allowed to make tax free "producers loans" to their U.S. shareholders. A partial repeal of the tax on interest paid to foreign corporations, e.g., solely for interest paid with respect to loans from FETI funds, could be considered to violate the GATT prohibition of an exemption from tax specifically related to export activities. There are alternative solutions to this technical problem which should mitigate if not eliminate a problem under the GATT.

Finally, safe harbor transfer pricing rules would apply for determining the amount of FETI allocable to the CFC on sales by a related supplier to the CFC. To be eligible for the safe harbor pricing rules, the CFC would be required to satisfy tests indicating that it conducted material sales and marketing activities in connection with its sales. The amount of a permissable safe harbor would be directly related to the amount of substantive economic activity conducted by the foreign corporation in connection with the export sale. While the Treasury is continuing to investigate the question, an allocation of 20 percent of the combined export income to a CFC with a material foreign presence may be justifiable in many circumstances as an arm's-length safe harbor, and would result in an export benefit roughly comparable to that provided under the DISC.

The foregoing proposal would be less vulnerable than the alternatives described above to attack under the GATT and the Subsidies Code. It would involve minimal changes to existing U.S. taxing rules and would be easily understood by most present DISC users. It would eliminate the need for the export receipts and export assets tests, and restrictions on the use of tax deferred earnings, all of which add great complexity and expense to and reduce the efficiency of the DISC. It would be a move toward restoring the tax treatment available to U.S. exporters prior to the 1962 enactment of the "tax haven" rules of Subpart F. As indicated earlier, this proposal has the two major defects of fostering additional economic activity outside the United States and promoting the use of tax havens.

Another major objection to the proposal is that it may be impractical for small businesses. Preserving the DISC for small business exporters or providing an exemption to the foreign presence requirements, however, would clearly constitute an export subsidy in violation of the GATT. These exporters could take advantage of the recently enacted Export Trading company legislation to facilitate their export transactions.

Analysis. Because it would encourage the location of economic activity outside the United States and promote the use of tax havens, the Treasury does not support the foregoing proposal. It would, however, comply with the GATT and the Subsidies Code, except for small business exceptions. This is because the deferral of tax would be with respect to income generated from economic activity located outside the United States and determined under arm's-length transfer pricing rules. It would in practice restore the tax treatment available to U.S. exporters prior to 1962.

IV. Non Tax Options

1. Export Credits

Instead of creating a tax alternative to DISC, another approach would be to strengthen other pro-trade policies. One way of doing this is through export financing.

A. Larger Eximbank Direct Credits

The need for adequate export financing is a pressing concern of U.S. exporters. Some major industrial countries -- most notably France and the United Kingdom -- have been aggressively using export credits to promote their exports. However, recent improvements in the OECD Arrangement on Guidelines for Officially Supported Export Credits in 1982, combined with falling commercial interest rates, have virtually eliminated subsidized export credits as a major problem. Nonetheless, the availability of a sufficient volume of credit remains important in light of ongoing LDC debt problems.

An enlarged Eximbank direct credit program would be one mechanism to assist U.S. exporters and increase credit availability. However, if this were to replace or partially replace the DISC incentives, the export community would need to have increased assurances as to the availability of adequate export finance. For example, major uncertainties are raised by the annual debate over the Eximbank budget and the size and availability of resources for export financing.

There are some major drawbacks to this approach:

-- The Administration's policy is to eliminate export credit subsidies, not expand them. We have largely achieved this goal as commercial interest rates converge with the minimum interest rates allowed under the OECD Export Credit Arrangement. Eximbank's subsidized direct credit program should be used only as a contingency reserve.

-- Subsidized Eximbank credits have been used only to counter foreign export credit subsidies, not to combat all export subsidies. An export credit program cannot be effectively targeted to match other types of export subsidies.

-- It may not benefit as wide a range of industries as DISC, and the incidence of its benefits will be different from that of the present DISC.

B. Larger Eximbank Guarantee and Insurance Program

Eximbank might also offer additional guarantees and insurance on loans to U.S. exporters from commercial banks. This would not require a direct budgetary outlay and would not be as costly as a direct loan program. This could help U.S. exporters obtain increased financing for exports from commercial sources at only a small cost to the government. The major benefit would be the availability of sufficient financing at market rates, which Treasury believes will be the key problem facing U.S. exporters in the 1980's.

C. Interest Rate Subsidies

As noted above, the OECD Arrangement clearly delineates the loan terms which its members can offer on export credits. This covers nearly all of the major industrial countries. Nonetheless, the Eximbank could retain flexibility to subsidize commercial loans so as to be able to match terms offered by other governments which aren't signatories of the Arrangement or members which do not adhere to its rules. This approach would be particularly attractive if market interest rates were at high levels. Nonetheless, such subsidies would not be advisable for several reasons:

-- They would reverse a long standing U.S. policy of opposition to export subsidies and would have all the drawbacks of an expanded direct credit program.

-- They would be a large budgetary drain.

-- They would be less cost effective than direct credits. Such subsidies would be used to bring commercial interest rates down from wherever they might be. On the other hand, interest rates on direct credits are based on the cost of money to the government and this means there is little or no subsidy element.

-- They would undermine U.S. ability to achieve other trade objectives in the GATT and the Subsidies Code.

-- They can be used only within fairly narrow limits. Any subsidies which go below Arrangement interest rate minimum for products covered by the Arrangement -- unless they were designed to match other offers -- would not be only illegal under the Arrangement but also under the GATT Subsidies Code which proscribes export credit subsidies other than at Arrangement terms. The Code does not proscribe non-subsidized lending based on cost of money to governments.

2. Other Non Tax Possibilities

A third approach would be to use DISC tax expenditures (currently $1.5 billion, declining) for other programs, either for general purposes or for a specific trade objective.

A. Agricultural Subsidies

DISC tax expenditures could be used to create a "war chest" to be used to subsidize agricultural exports, consistent with

GATT. GATT permits export subsidies for agricultural products as long as the subsidies do not result in the subsidizer taking an "inequitable" share of world trade or pricing at levels "materially below these of other suppliers".

The war chest could be used flexibly and targeted at European Community agricultural subsidies. The objective would be to force the EC to the bargaining table -- and to give us leverage in the negotiations. There is a certain justice in using the DISC funds against the EC's Common Agriculture Policy since it was the EC that led the attack against DISC in GATT.

Nonetheless, there are strong arguments against a large "war chest" for agricultural subsidies:

-- They may be ineffective. The EC might simply match them.

-- Once we start subsidizing, it might be impossible to stop unless agricultural prices rise sharply. They might become a new entitlement program.

-- They would not help the main receivers of DISC benefits, exporters of manufactured products. In fact, to the extent the subsidies increase U.S. agricultural exports and thereby strengthen the dollar, exporters of manufactured products would be hurt.

B. Structural Adjustment

Another possible program is to help U.S. industries and labor adjust to foreign competition. This program might entail U.S. government support for private training of workers and for modernizing plants. It could be targeted to those industries where the U.S. has a longer term comparative advantage and where our export possibilities are the greatest. (However, in order to be GATT legal it would have to be set up as a production incentive rather than an export incentive.) It could also be used to help import competing industries.

A special fund could provide matching funds to industries which wish to upgrade worker skills, to modernize production facilities, or to move into new product lines in order to become more internationally competitive. These funds could be either grants or low cost loans. At the outset it would be specified that those industries which qualified for the program would be expected to agree to a progressive reduction in the level of protection, both tariff and non-tariff barriers, over time.

Disadvantages include:

-- the negative budgetary impact would be the same as DISC;

-- it would likely tend to help import competing industries more than export industries; and

-- it is inconsistent with the Administration's economic philosophy of reducing government subsidies and government interference in business decision making.

C. Increased Research and Development Funding

Another possible program to encourage exports and help import competing industries would be matching funds, either through grants or low cost loans, for research and development costs. It would be targeted at specific industrial groups or sectors. However, the incentive could not be tied directly to exports because of GATT prohibitions. High technology and sophisticated capital goods industries would likely be the major beneficiaries. Again beneficiary firms would be expected to agree to a progressive reduction of domestic protection.

Drawbacks of this approach include:

-- the negative budgetary impact;

-- problems in electing eligible industries (both in terms of GATT legality and domestic political considerations); and

-- it would not have significant impact on exports for several years.